AUDITOR GENERAL
Alberta

Auditing for the Public

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Preface

Auditors act on behalf of funders, being taxpayers or shareholders, to add credibility to financial statements prepared by management.

In the public sector, there is a long history of taxpayers, represented by legislators, appointing the auditor. In this way, the auditor is independent of the government of the day, government-appointed boards, and management.

In the private sector, shareholders delegate to directors the job of appointing the auditor. This practice has resulted in instances where inappropriate influence has been exercised by directors.

Some directors and managers of public resources in Alberta now argue that they should appoint their auditor. This paper explains why this would not be in the best interests of taxpayers.

Failing the appointment of the Auditor General, MLAs should ensure that the auditor appointed has the same mandate and responsibilities as the Auditor General. This can in fact be achieved if the auditor is appointed as agent of the Auditor General. The paper explains that the Auditor General has used private sector auditors cost-effectively for many years.

Development of Legislative Auditing

Athens

In the state of Athens, before 300 BC, a body of accountants had already been formed specifically for the supervision and auditing of public finance. These expert auditors were called logistae. The logistae together with a ten person group elected by the public were responsible for the audit of managerial accounts. They paid special attention to the accounts of people leaving a public position that involved management of the state's money.

Great Britian

Public sector auditing in the United Kingdom has a long pedigree. The first Comptroller General of the Exchequer was appointed in 1314 and successive audit bodies were established over the next 500 years. The present Office of Comptroller and Auditor General (C&AG) was created by statute in 1866.

The National Audit Act (1983) reinforced the C&AG's financial and operational independence from the Executive and established a closer working relationship with Parliament. It created the National Audit Office with the C&AG as its head; established a clearer framework for his access to departments and many other bodies receiving public funds; and provided statutory authority for his work on economy, efficiency and effectiveness.

United States

The concept of independence for the Comptroller General received strong support during congressional debate in 1919 and 1920. The Budget and Accounting Act of 1921, which created GAO (the General Accounting Office), represented a substantial change in the US financial management system. For the first time in the nation's history, an organization independent of the executive departments gained responsibility for auditing executive branch financial actions. The 1921 law remains the primary source of the GAO's legislative authority.

It is notable that in a number of the states, the state auditor is elected thereby ensuring the independence of the position.

Canada

Early Canadian experience demonstrated the desire of Parliament to have control over the public purse and to have a strong, independent Auditor General. The basic principles of control over supply and audit were established as a countervailing power to the governor and his council.

Gradually over the course of 100 years, and then dramatically in 1977, the emphasis changed from the prevention of fraud and assurance of probity to the more complex task of providing Parliament with the information needed to oversee the use of the public purse.

Over the years, a clear concept of the Office of the Auditor General of Canada as an instrument of Parliament has evolved—a concept confirmed in the Auditor General Act of 1977, which greatly broadened the audit scope. The Office has played a key role in increasing the emphasis on the accountability of the government to the people it represents, and whose money it spends.

Alberta

The Office of the Auditor General was established in 1978; the origins of the former Provincial audit office go back to 1905. Our links to the Legislature are through two committees: the Standing Committee on Legislative Offices, and the Public Accounts Committee.

Accountable to the members of the Legislative Assembly, we are responsible to the public who want assurances that the government's financial reporting is credible. Consequently, our core opinion work is performed to add credibility to the financial reports of organizations accountable to the Assembly. But our legislators have wanted more. In effect, we are charged with making recommendations to improve the economic and operational health of the Province.

The Auditor General is to report on the adequacy of accounting systems and management control systems, including those designed to ensure economy and efficiency. In practice, "systems" means more than computers; it also includes management structure and regulatory administration, and all those things essential to the successful operation of any program or organization. Our work provides independent information, advice and recommendations to Members of the Legislative Assembly and the public concerning the financial operations of Provincial entities.

The public and the MLAs that represent them want the government to be accountable. They want clear accounting policies that require losses and liabilities to be recognized as they are incurred. They want realistic business plans and budgets, and they want the public debt to stop growing. They want clear financial reporting that shows the cost and effect of operations. The Auditor General is seen as someone who is independent of government who acts as a watchdog on behalf of the taxpayer. By encouraging the use of more realistic and appropriate accounting policies, by promoting the prompt reporting of results, by helping to incorporate performance information in financial reports, and by providing recommendations for business practices that work, the Auditor General has improved the relevance of public accounts and the effectiveness of government. It is for these reasons that government and opposition MLAs and the public value the audit opinions and recommendations of the Auditor General.

The Independent Audit of Public Resources

Independence

The authority and value of the legislative audit derive entirely from the fact that the auditor in expressing an opinion does so independently: "Since the time of Aristotle it has been accepted principle that state auditors should be free from direction, influence and intimidation by, and income or reward from, the authorities and persons whose affairs they are called upon to audit. No state auditor, or at any rate no chief state auditor, can afford to be without independence; he needs it as a judge needs it, in order to be impartial and fearless in criticism. He also needs it in order to be able to publicise his criticism in an open report."1

The view of this author is shared by many auditors, researchers, and administrators who consider the concept of legislative examination of the executive to be a foundation that cannot be undermined in a democracy. Public confidence in legislative auditors will be sustained only if they are seen to be independent of government.

The parties

In the public sector, where auditing began, there are four principal parties to an audit:

1. funders, being taxpayers represented by legislators,
2. directors, being government; or boards of directors appointed by government,
3. management appointed by directors, and the auditor.

Ideally, for audits on behalf of Members of a Legislative Assembly, the objective is to secure arrangements so that auditors are not exposed to pressure, either overt or indirect, which could affect their impartiality and objectivity, or which could induce others to believe that this might be so. For this reason, the auditor of public resources has traditionally been appointed with the approval of all legislators rather than by the government.

The basic principle followed in the public sector is that the appointment of auditors should not be made by persons whose position may be affected by the outcome of the audit and/or who have an interest in influencing the auditors in their investigation or report.

Although the parties to the audit are essentially the same in the private sector:

1. funders, being the shareholders,
2. directors,
3. management appointed by the directors, and

1 Normanton, E.L. *The Accountability and Audit of Governments* (page 298).

4. the auditor, the method of appointment of the auditor is an issue.

Appointment of auditors in the private sector

Financial statements are accountability reports to shareholders. They are also used by creditors and lenders. Auditors add credibility to the financial statements prepared by management. Ideally, directors or the management of a company should not appoint the auditors.

The prevalent practice of shareholders delegating to directors the job of appointing the auditor is in principle flawed. The fact that shareholders retain the power not to endorse the directors' recommendation, and have on occasion exercised it, does not ensure that the practice invariably operates in the public interest in all other cases.

The practice in recent years of directors entertaining competitive presentations from a number of auditors as a basis for making a selection has the potential to threaten the auditor's independence. While competition and the practice of outlining the audit together with a fee quotation are themselves desirable, the procedure gives the directors the opportunity to exercise improper influence. Directors who have an interest in minimizing the scope and depth of the audit and who make a selection wholly on the basis of lowest fee, are not necessarily serving the interest of the parties who depend on the auditor.

In the case of private sector organizations where there are no shareholders, such as pension funds, charities, and condominium associations, the step of funders ratifying the directors recommendation is dispensed with, as directors generally have total control over the appointment of an auditor.

Giving the job of appointing an auditor to the persons who are subject to audit is prejudicial to audit independence.

The consequences of a less than perfect appointment system were summed up in the 1986 Estey report:[2]

- "...led to the dropping by management of Clarkson, Gordon from the audit rotation for the year 1985 as earlier discussed. When these events are assessed with a similar incident in 1980, they greatly reinforce the conclusion that bank management effectively controlled the appointment of auditors according to their own interests and not necessarily those of the shareholders who appoint them"; and

[2] *Report of the Inquiry into the Collapse of the CCB and Northland Bank* by The Honourable Willard Z. Estey, 1986, (pages 246 and 247).

- "Interference by management in the process of the appointment by shareholders of auditors in the bank makes a farce out of the theory that the auditors are appointed by and for the benefit of the shareholders."

Argument for shareholder appointment of auditors

The Macdonald Commission (1988) which studied the public's expectations of audits identified a perception that auditors were not satisfactorily independent of management in making their determinations. Seven years later, the problem persists.

The perception that auditors are not independent of the management they audit and that public confidence is being eroded is supported by the following arguments:[3]

- Shareholders or their representatives should hire and fire the auditor and determine audit fees; as a practical matter they do not.
- Auditors are often seen as advocates for management positions rather than serving the interests of shareholders and other stakeholders.
- Auditors are seen to use the audit as a "loss leader" to obtain advisory services, with the consequence that audit quality may be declining. As a result, errors, illegal acts and fraud may go undetected.
- Auditors are dependent on management for their livelihood and may not have the objectivity to take a "tough stand" when, for example, material misstatements are detected in the entity's financial statements.

Solutions

In the private sector, the solution to the problem of auditor independence lies in using a committee of shareholders to appoint the auditor. Ironically, such committees, aptly named audit committees, already exist in most large private sector organizations. The challenge is to make these committees independent of management and to make them responsible for appointing the auditor. It is recognized that to achieve this would require a change in corporate law.

In effect, the solution to auditor independence in the private sector is to follow the long-established precedent in the public sector. The auditor must be appointed by the funders rather than by the directors or management. In the public sector, the Auditor General is appointed by all MLAs on behalf of the taxpayers.

The appointment of the Auditor General does not exclude the private sector from the audit of public resources. On the contrary,

[3] *Professional* Judgment *and the Auditor* Research Report by the Canadian Institute of Chartered Accountants, 1995

the practice of the Auditor General appointing private sector auditors to act on his behalf is effective. The arrangement works to provide private sector auditors with the independence of the Auditor General. As long as the Auditor General, as opposed to directors or management, appoints another auditor (as agent), public confidence in legislative auditing will be sustained.

Advantages of having Public Resources audited by an Auditor General

Track record

All public managers, administrators and regulators bear responsibility for identifying problems, marshalling resources, motivating people and making operations work. Public funds must be spent more wisely, and programs must be made to run more efficiently at less cost.

Legislative auditors are in business to encourage beneficial change and to help secure improved systems and controls for the future. In Canada, they are well equipped professionally. Quality of work is high, with standards for financial audit matching those in the private sector, supplemented by additional responsibilities for propriety and legislative compliance. Furthermore, legislative auditors have for many years been carrying out examinations of economy, efficiency and effectiveness going well beyond private sector requirements.

Auditor General of Alberta

We also have in-depth expertise on questions of public accountability, and experience of working for and with the Legislative Assembly.

Making us operationally independent from government control does not, of course, mean that the Legislature's views are neglected. We remain responsive to the interests and wishes of the Legislature, and regular and effective consultation is essential. For practical reasons, such consultation is concentrated on committees of the Legislative Assembly, such as the Public Accounts Committee, rather than with the Legislature as a whole or with individual members.

Our success depends on our auditors being useful to legislators and the public.

Achievements

The Office has never viewed adding credibility to financial reports as a discrete end in itself. The process for adding credibility-the financial statement or opinion audit-is the natural vehicle for encouraging improved financial reporting.

The fact that the Province of Alberta is the leader in public financial reporting-both in terms of relevance and timeliness-is testimony to progressive Treasury Department thinking and this Office's

consistency of principle. We are in business for the long term and can therefore encourage the use of improved accounting principles without regard to short-term expediency. Undoubtedly the economic imperatives of the late 80s and early 90s spurred change. But it should be remembered that this Office advocated consolidated financial statements, pension liability accrual, the recording of losses on guarantees, and performance measurement and reporting long before it was fashionable to do so.

Currently, we are taking an active lead in promoting the improved accountability that will result from measuring and reporting the cost and effect of government programs and services. Our initiative to add credibility to the government's performance reporting is unparalleled in Canada, and we believe will result in the acceleration of the relevance of that reporting.

Our ability to take a position, provide advice, actively participate in necessary experimentation without compromising our objectivity, and sustain the implementation process over a long term, are advantages that we strive to maintain. These advantages, though, do not volunteer themselves. In the main, they arise from:

- long experience of working in the public sector,
- understanding the reasons for particular methods of accounting and reporting, and the perceived impediments to change,
- active participation in public sector standard setting,
- access to the network of detailed knowledge and initiatives of legislative auditors in Canada and worldwide, and
- our independence, both actual and perceived.

Our whole approach to helping government work as effectively as possible is based on using the knowledge of operations gained during the attest audit process. It is this knowledge of business and risk that allows us to efficiently merge the effort to improve the relevance of public reporting with effort to improve financial administration through better systems and processes.

Agents

As a matter of strategy, we make substantial use of private sector firms as agents to supplement our own resources. Our practice benefits for reasons including:

- we can use particular skills cost-effectively;
- we gain a point of reference for comparing our methodology and cost; and
- we are able to supplement our staff to meet the demands of peak work periods.

Recently, certain health authorities recognized our responsibility as legislative auditor and have appointed the Auditor General as the auditor of their regions in order to facilitate the legislated

accountability process. We believe that this arrangement will provide a cost-effective attest audit of the financial statements and also permit us to meet our reporting responsibility to the Legislature. Where the Auditor General has been appointed the auditor of a health authority, he intends to appoint a private sector audit firm as his agent to perform the audit of the required financial statements.

Our Accountability

Charging fees

Independence gives authority, freedom and opportunity. It also imposes responsibilities.

As accountants we know that measuring and reporting the cost and effect of services provided invariably leads to reduced cost and improved service. The Office of the Auditor General has already begun to assess and report the cost and value of our opinions and recommendations so that we are accountable for our own operations.

Recently, we advised our clients that we would begin to charge an audit fee for the cost of our attest audit services. The purpose of this new policy was twofold. Firstly, it would help all organizations account for the cost of all of their inputs, resulting in an accurate reporting of the costs of their outputs. And secondly, it would implement a fiscal discipline in our Office such that economies and efficiencies appropriate for the Office are achieved in a manner that enables the Office to continue to be accountable to the Legislature.

The notice to our clients of this new policy has caused substantial comment. Many organizations do not yet subscribe to the full costing concept. This is particularly true for a number of the larger departments and revolving funds. Despite the fact that fees collected by the Office will be deposited in the General Revenue Fund and be available to fund our clients, the almost unanimous reaction has been that we are downloading our costs without providing a source of funding.

While the implementation of the new policy is a goal of the Office, and is supported by the Standing Committee on Legislative Offices and the Provincial Treasurer, it is premature for the following reasons:

- the government and the Office have not established an appropriate mechanism to account for and fund the cost of attest audits performed by, or under the direction of, the Office; and
- an appropriate communication system with our clients has not been effected.

In light of the foregoing, we will postpone the implementation of this portion of "full costing" until such time as there is clear support for the concept and an appropriate mechanism has been developed for budgetary and accounting purposes.

Our performance reporting

We believe that in order for performance information to be really useful, it should be audited. The best way to make sure this happens is to include accurate performance information in audited financial statements. The most recent financial statements of the Office of the Auditor General have changed substantially from previous years, and go a long way towards improving our performance reporting, and thus our accountability.

Our statements now conform with generally accepted accounting principles. More importantly, they mean that we are able to report the full cost of our operations, so that we can meaningfully compare our costs to those of other auditors.

The financial statements contain supplementary performance information designed to assist in evaluating the Office's performance. The Auditor General has explicitly asserted in the financial statements this quantifiable information is relevant and reliable. And our auditors have attested to that assertion. The additional performance information is in three schedules at the end of our financial statements: Output costs by ministry; Recommendation work and status of recommendations; and other performance information.

Anyone interested in assessing the performance of this Office is encouraged to review our financial performance in relation to our budget, along with the above three schedules. They represent our first effort at more comprehensive performance reporting.

Our operational systems are fully integrated with our financial systems. This allows us to accurately compute the cost of our work and the outputs we produce. It also allows us to attribute the costs and revenues associated with our audits to the individual employees who do the work. We produce individual contribution statements for each auditor, which are used to help us assess their personal contribution to achieving our business plans. We believe such performance information is necessary to ensure that we appropriately recognize performance, and that this in turn leads to improved productivity.

Conclusion

It is important to appreciate that effective audit independence cannot be created by edict. And legislative auditors will not secure true independence unless they are determined to be independent and show this in how they tackle their work.

The appointment of a legislative auditor should not be in the hands of government. Likewise, auditors of boards or Provincial agencies using public resources should not be appointed by the board or the agency or by the respo sible minister.

Unfortunately, political and bureaucratic interests can disregard these concepts. To ensure that the public benefit of our service is not lost, the Office of the Auditor General of Alberta needs continuing support from the Legislature, from legislative committees and from individual members. We believe we can maintain such support on the basis of our skills, experience and expertise, and above all the accuracy, balance and relevance which we bring to our work, to our dealings with audited bodies, and in our published reports.

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